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Fusions & Acquisitions
La première revue des rapprochements d'entreprises

IPEM – Europe 2020

Vol. 3, 2020

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How Private Equity can leverage downturn M&A for value creation

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1 Introduction

This article connects our research on downturn M&A with the perspective of Private Equity (PE) firms. With respect to the current Covid-19 pandemic, this topic should be especially relevant for PE firms considering M&A at their portfolio companies.[1]

In mid-March 2020, the pandemic brought M&A activity of both, corporate and PE dealmakers, almost to a halt. The number of PE deals in April 2020 was more than 70% lower than in December 2019 (see exhibit 1). Across the globe, dealmakers had to face a new work reality. The inability to conduct business as usual – such as face-to-face meetings with the management teams of target companies – was a major impediment. As a result, PE firms initially pulled back despite sitting on record amounts of dry powder.

Instead of making new deals, PE firms gave priority to assessing the impact of the pandemic on their current portfolio.[2] Being hit hard by the crisis, some portfolio companies required attention, especially in heavily impacted consumer sectors and sectors that had already been facing headwinds. In some cases, additional debt or equity financing, or even some sort of financial restructuring, was necessary.[3]

But after a few months, PE firms switched gears and started to engage in new deals, leading to a quick recovery in PE deal activity that reached precrisis levels already in August. This trend is confirmed by a recent survey that finds that PE managers are seeking new investment opportunities despite the ongoing pandemic.[4] At the same time, they are also putting more weight on top-line growth as a lever to value creation. And acquisitions can be a major part of such growth strategies for portfolio companies.

2. Leveraging the Downturn for Superior Returns

PE firms that have resolved or gained control of Covid-19-related issues will quickly resume looking for ways to invest their record levels of dry powder. Many senior PE executives will likely recall that some of their most successful deals were the investments made during and shortly after the 2008–2009 financial crisis. This is, for example, apparent in the fact that, on average, PE funds set up in 2009 clearly outperformed those in earlier and later years (see exhibit 2).[5]

But value creation through deals in tough economic times is far from certain. As for regular corporates, what matters is the strategy that PE firms set for their portfolio companies. In the current environment, we expect several M&A strategies to be successful:

1. *Consolidation:* Even well underperforming industries have the potential to produce successful companies – and using a portfolio company to consolidate a certain market can be a promising approach.

1 A related article focusing on downturn M&A in Germany, Austria, and Switzerland has appeared in the German M&A Review (see Degen/Kim/Kengelbach/Sievers: Downturn M&A: Die Erfolgsstrategie der Stunde?. M&A Review, 2020, vol. 9, p. 266-271).

2 About 50% of the PE portfolios have been adversely affected by the pandemic (see Gompers/Kaplan/Mukharlyamov: Private Equity and COVID-19. Georgetown McDonough School of Business Research Paper No. 3694159, 2020, Available at https://ssrn.com/abstract=3694159); see also, Bernstein et al. mentioning, "As just one example, by December 2008, the Private Equity fund Bain Capital had shifted all of its 175 investment professionals from seeking out new deals to developing and implementing action plans to help its portfolio companies survive the downturn." (see Bernstein/Lerner/Mezzanotti: Private Equity and Portfolio Companies: Lessons from the Global Financial Crisis. Journal of Applied Corporate Finance, 2020, vol. 32, no. 3, p. 21-42).

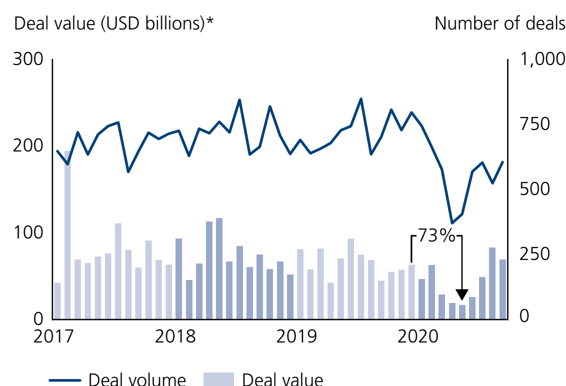
3 See Haarmeyer: Private Equity and the COVID-19 Economic Downturn: Opportunity for Expansion?. Journal of Applied Corporate Finance, 2020, vol. 32, no. 3, p. 87-91.

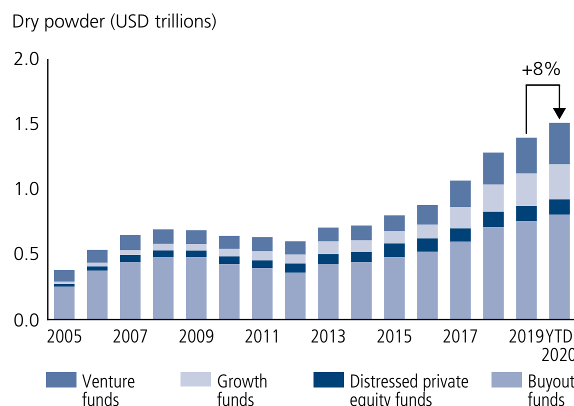
4 See Gompers/Kaplan/Mukharlyamov: Private Equity and COVID-19. Georgetown McDonough School of Business Research Paper No. 3694159, 2020, Available at https://ssrn.com/abstract=3694159.

5 Consistent with these results is the finding by Haarmeyer stating, "Generally, the best vintages coincide with dislocations in public equity markets when assets can be acquired near the bottom of the pricing curve and later exited once markets recover. As examples, 2008 and 2009 vintage buyout funds had median net IRR of 13.4% and 14%, respectively, higher than those of the three previous years." (See Haarmeyer: Private Equity and the COVID-19 Economic Downturn: Opportunity for Expansion?. Journal of Applied Corporate Finance, 2020, vol. 32, no. 3, p. 87-91). Looking at longer time series provided by Harris, Jenkinson and Kaplan starting in 1984 and ending in 2008 also shows that vintage funds, for instance, raised after crises (e.g., the dot-com bubble in the early 2000s) show superior performance (see Harris/Jenkinson/Kaplan: Private Equity Performance: What Do We Know?. Journal of Finance, 2014, vol. 69, no. 5, p. 1851).

Fig. 1 • Development of the Private Equity market

Source: BCG M&A Report 2020 (Exhibit 5, p.17); Refinitiv; Preqin; BCG analysis

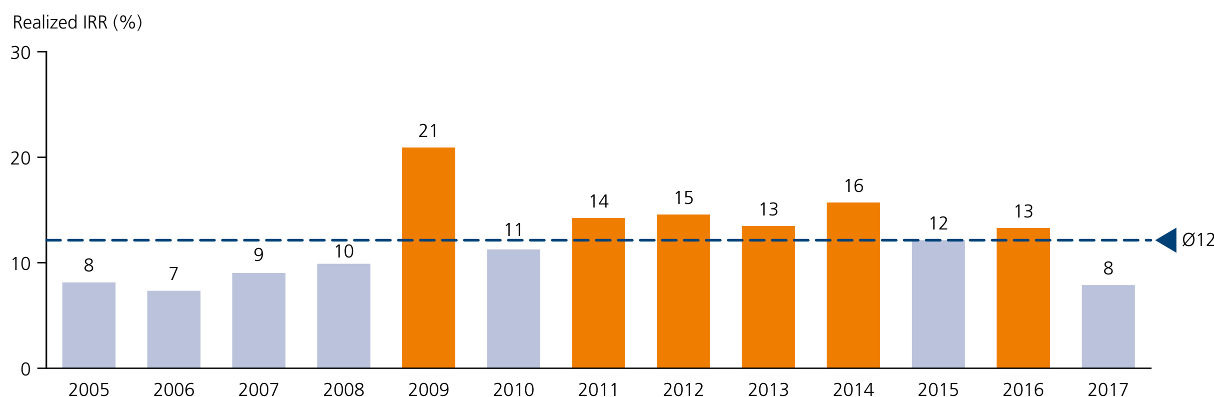




* Deal value includes assumed liabilities.
Note: PE deal activity includes buy-side and sell-side involvements of financial sponsors; Numbers updated and extended including September 2020.

Fig. 2 • The last crisis created some of the best-performing PE funds

Source: Pitchbook; BCG analysis; Own illustration



Note: Buyout focused funds only; according to vintage year.

2. *Buy & build:* Taking advantage of downturn opportunities, PE firms can use portfolio companies as a platform to acquire further companies and build a market leader.

3. *Transformative M&A:* If a portfolio company is heavily and/or adversely affected, it might be worth doubling down and transforming the company through a decisive transaction.

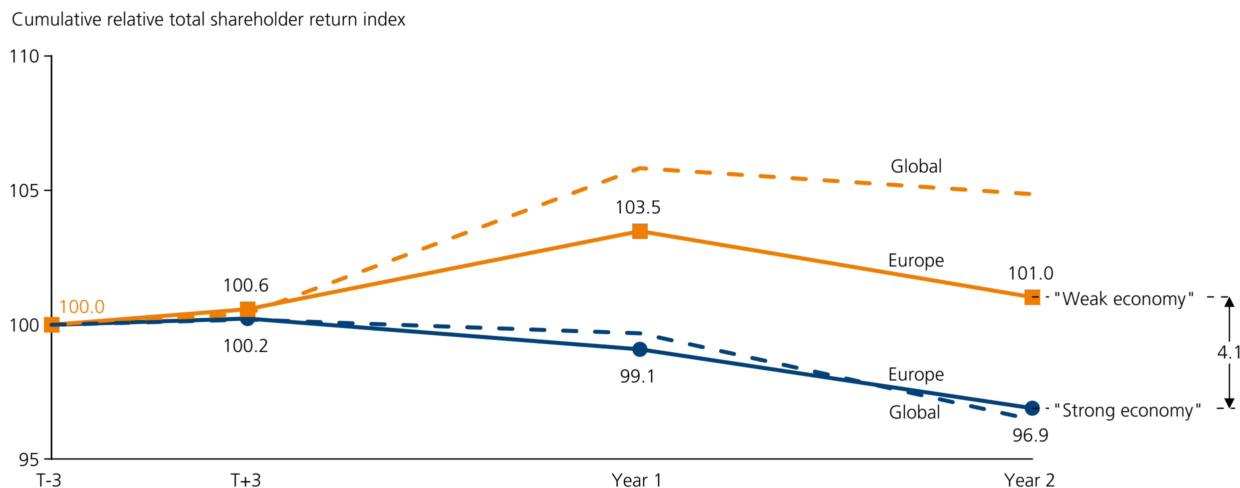
Also, we expect alternative structures to play an important role in PE firms' strategies. Instead of fully acquiring a company, they might consider partnering up with other financial sponsors or strategic acquirers, provide companies with growth capital or finance transformations or turnarounds with private investments in public equity (PIPE).[6]

In the following, we will substantiate that the above-mentioned strategies – which mostly rely on using a portfolio company to acquire other companies – can in fact be value creating. The focus of our analyses is European companies.

6 See Kengelbach/Keienburg/Degen/Soellner/Kashyrkin/Sievers, The 2020 M&A Report: Alternative Deals Gain Traction, Boston Consulting Group, 2020.

Fig. 3 • Are bad times actually good times? The fact is, acquisitions in downturns create more value

Source: Refinitiv; BCG analysis; Own illustration



Note: Majority transactions with a valuation of at least 250 million USD by publicly listed buyer companies; breakdown into a "strong" and "weak" economic times based on global real GDP growth. Analysis includes 9,987 transactions, 2,549 of them in Europe.

3. Bad Times Are Good Times – at Least for Acquisitions

Our analyses confirm that periods characterized by high uncertainty and poor fundamentals provide optimal conditions for value-creating M&A transactions (see exhibit 3).

We studied the success of European acquirers in M&A transactions using relative total shareholder return (RTSR) as the performance metric.[7] The primary result is that transactions that take place in weak economic times yield significantly higher RTSRs. As the returns in our analysis are adjusted for industry returns, the result cannot be interpreted as stemming from the general market recovery following a downturn.

Comparing European acquirers with the global data set, value creation from weak-economy deals declines after the first year, and the overall level is considerably lower. This indicates that European acquirers seem to be good at realizing quick wins from transactions but are struggling with long-term value creation. They also seem to benefit less from taking over targets during a downturn compared to global acquirers.

There are a few explanations for this phenomenon. For instance, we know from US studies that transactions during periods with high M&A activity (so-called in-wave deals) are often beset by greater economic uncertainty, poorer forecasts from financial analysts, and less-frequent changes in management for poor performance. This aligns with the observation that in-wave target companies are often not optimally selected, integration is not goal-oriented, and management is not held responsible to the same extent as in periods with less M&A activity (so-called out-wave deals).[8]

Our results indicate that the strategies listed above are best carried out in a weak environment. However, there is another important factor to deal making that is hard to replace: experience.[9] For example, if we observe the RTSR two years after a deal is made, we see that experienced acquirers[10] generally manage to realize

7 Relative total shareholder return (RTSR) compares total shareholder return (TSR) with the return of an industry-specific benchmark index to determine excess return. TSR is the period-specific overall equity investor return, comprised of dividend yield and price yield. For more RTSR information and findings, see, e.g., Ma/Shin/Wang: rTSR: When Do Relative Performance Metrics Capture Relative Performance?. Harvard Business School Accounting & Management Unit Working Paper, 2019, no. 19-112, Available at https://ssrn.com/abstract=3380516.

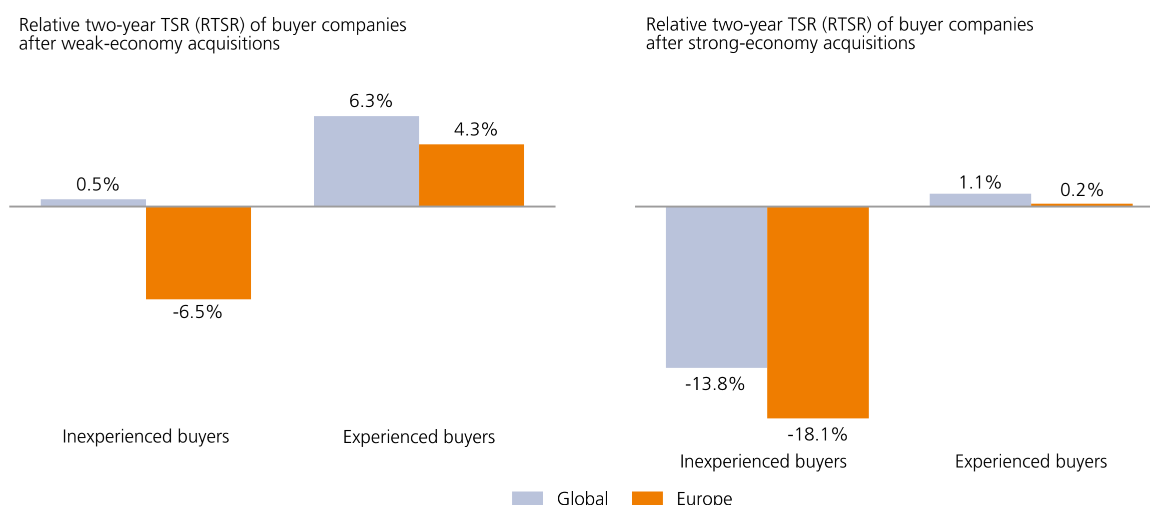
8 See Duchin/Schmidt: Riding the Merger Wave: Uncertainty, Reduced Monitoring, and Bad Acquisitions. Journal of Financial Economics, 2013, vol. 107, no. 1, p. 69–88.

9 See Kengelbach/Keienburg/Bader/Degen/Sievers/Gell/Nielsen, The 2019 M&A Report: Downturns Are a Better Time for Deal Hunting, Boston Consulting Group, 2019; Kengelbach/Keienburg/Schmid/Sievers/Mehring The 2016 M&A Report: Masters of the Corporate Portfolio, Boston Consulting Group, 2016; and Fuller/Netter/Stegemoller: What Do Returns to Acquiring Firms Tell Us? Evidence from Firms That Make Many Acquisitions. Journal of Finance, 2002, vol. 57, no. 4, p. 1763–1793. Other studies, such as King/Dalton/Daily/Covin: Meta-Analyses of Post-Acquisition Performance: Indications of Unidentified Moderators. Strategic Management Journal, 2004, vol. 25, no. 2, p. 187–200, conclude that experience per se has no positive influence. The authors suspect other unknown variables that correlate with experience to be the underlying driver. However, Atkas, de Bodt and Roll provide strong evidence that learning through repetitive acquisitions is a major factor for successful M&A (See Atkas/de Bodt/Roll: Learning from Repetitive Acquisitions: Evidence from the Time between Deals. Journal of Financial Economics, 2013, vol. 8, no. 1, p. 99-117)

10 For our analysis, we defined an "experienced acquirer" as one who has executed more large transactions (valued at over USD 25M) than the median of all companies during the same period.

Fig. 4 • Experienced buyer companies realize higher returns; Companies in Europe often lack experience

Source: Refinitiv; BCG analysis; Own illustration



Note: Majority transactions with a valuation of at least 250 million USD by publicly listed buyer companies; breakdown into "strong" and "weak" economic times based on global real GDP growth worldwide; classification in "Inexperienced buyers" (≤ 3 in our sample) and "Experienced buyers" (> 3) based on number of transactions. Analysis includes 33,045 transactions, 8,021 of them in Europe.

significant excess returns, especially in a downturn (see exhibit 4). In contrast, value creation for unexperienced acquirers is a mixed bag, only generating value with downturn M&A.

The corresponding analysis for European acquirers shows similar results except for one key area: Inexperienced buyers struggle to create value from deals even in weak economic times, which is supposed to be the best time for M&A.

These results emphasize the argument that presumably "bad" times do provide good conditions for successful acquisitions, but this is not equally true for all companies. M&A skills are a key success factor.

4. Deal Making Experience and Skills Matter

The results from the previous sections suggest that an economic downturn might be the prime time for PE firms to think about M&A strategies such as "buy & build" or "transformative M&A" for their portfolio companies. Our findings also imply that timing alone does not make for a successful strategy. In addition to the quick and careful execution of the transaction, the effective integration of the target company is decisive. Detailed preparations and wide-ranging expertise further improve the chances of success.

4.1 Thorough Preparation Creates New Opportunities

Based on the company's growth and portfolio strategy, a systematic approach should include a detailed catalog of requirements, and based on this, an initial list of suitable target companies—even if they are currently not for sale or considered to be too expensive. Continuous updates ensure that the approach is aligned with market or strategy changes. This way, companies can make quick and decisive use of the opportunities that arise in a downturn.

It can also be smart to use economic slowdowns to screen the market for opportunistic situations. Almost every downturn presents opportunities to acquire fundamentally healthy companies at attractive valuations. Furthermore, maintaining a continuous dialogue with investment banks and other advisors helps companies to keep an eye on the market.[11]

A capable M&A organization with the relevant capabilities and responsibilities as well as established processes helps companies and their PE owners to get the ball rolling on an acquisition quickly, should the

11 For empirical support of this issue see Golubov/Petmezas/Travlos: When It Pays to Pay Your Investment Banker: New Evidence on the Role of Financial Advisors in M&As. Journal of Finance, 2012, vol. 67, no. 1, p. 271-312.

occasion arise.[12] Especially in economically difficult times, potential acquisition financing should be thought through beforehand in order to be able to utilize options quickly.

4.2 Expertise Increases the Chance of Value Creation

Expert knowledge and routine processes enable quick action without neglecting thorough due diligence and rigorous decision-making. Experience shows that seller companies prefer sophisticated buyers in transaction processes, because they ensure a certain level of professionalism. But a recent BCG survey of M&A decision-makers showed that only 15% of respondents had experience with transactions in an economic downturn.[13] This increases the importance of support by the PE team, which can usually bring considerable deal experience to the table.

Experienced dealmakers also have a keen sense of when it's time to abandon a proposed transaction. Acquirers and their PE sponsors can leverage their expertise to quickly determine the stand-alone value of a target company and estimate the willingness of other potential bidders to pay the price. Not every acquisition to engage in industry consolidation automatically leads to value creation. A thorough and realistic assessment of the synergy potential and additional economies of scale and scope should ensure a fair purchase price.

The assumption that a "bargain" acquisition will automatically create value is therefore misleading. Rather, the target company – if desired[14] – needs to be quickly and rigorously integrated, because the majority of synergy measures, especially cost initiatives, should be implemented within one year. Integration plans should include detailed synergy tracking and monitoring. At the same time, companies should keep their eyes open for additional value levers on both the buyer side and that of the company to be integrated. In many cases, synergy planning can be adjusted after a "getting acquainted" phase, with better information and more realistic assessments. This integration and value creation process requires sufficient and adequate resources on the portfolio company level, as this is oftentimes not a core competency of PEs.

In any case, the time and resources required for ongoing transactions should not be underestimated—especially on the management and PE fund level. Experienced buyers know that they can't afford to neglect day-to-day operations during this phase.

5. Conclusion

Downturn M&A, in other words, transactions initiated in economically difficult times, are often viewed particularly critically by management and supervisory boards as well as investors. Our analyses, however, show that oftentimes these are deals with significant value creation potential. When it comes to the current Covid-19 crisis – whose ultimate duration and economic impact cannot yet be determined – companies should not automatically shy away from transactions in the face of adverse conditions.

Aside from the right timing, there are a few rules that need to be observed. For instance, M&A strategy and deal rationale must be consistent with the company's growth and portfolio strategy. In addition to this, thorough preparation, sufficient expertise, and quick and careful execution are key factors for long-term success. PE firms should also make sure that the company has the necessary resources for a swift and rigorous integration of acquisitions.

In short, PE firms that are able to take advantage of current opportunities might create another "golden vintage year." Our findings also imply that providing portfolio companies with two critical resources can create tremendous value: funding to pursue an acquisition strategy, and the PE team's deal experience to execute the M&A strategy and create value from it.

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12 On evidence regarding internal M&A process organization and M&A success see Schmitz/Sievers: What matters for organizing M&As successfully?. Paderborn University Working Paper, 2020, Available at SSRN: https://ssrn.com/abstract=3679155.
13 See BCG Investor Pulse Check #11, Boston Consulting Group, 22 October 2020, Available at https://www.bcg.com/de-de/publications/2020/covid-investor-pulse-survey/overview.
14 Some targets are intentionally kept as an independent stand-alone entity or only loosely integrated.